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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY,
*Petitioner,*

—v.—

UNITED STATES OF AMERICA,
*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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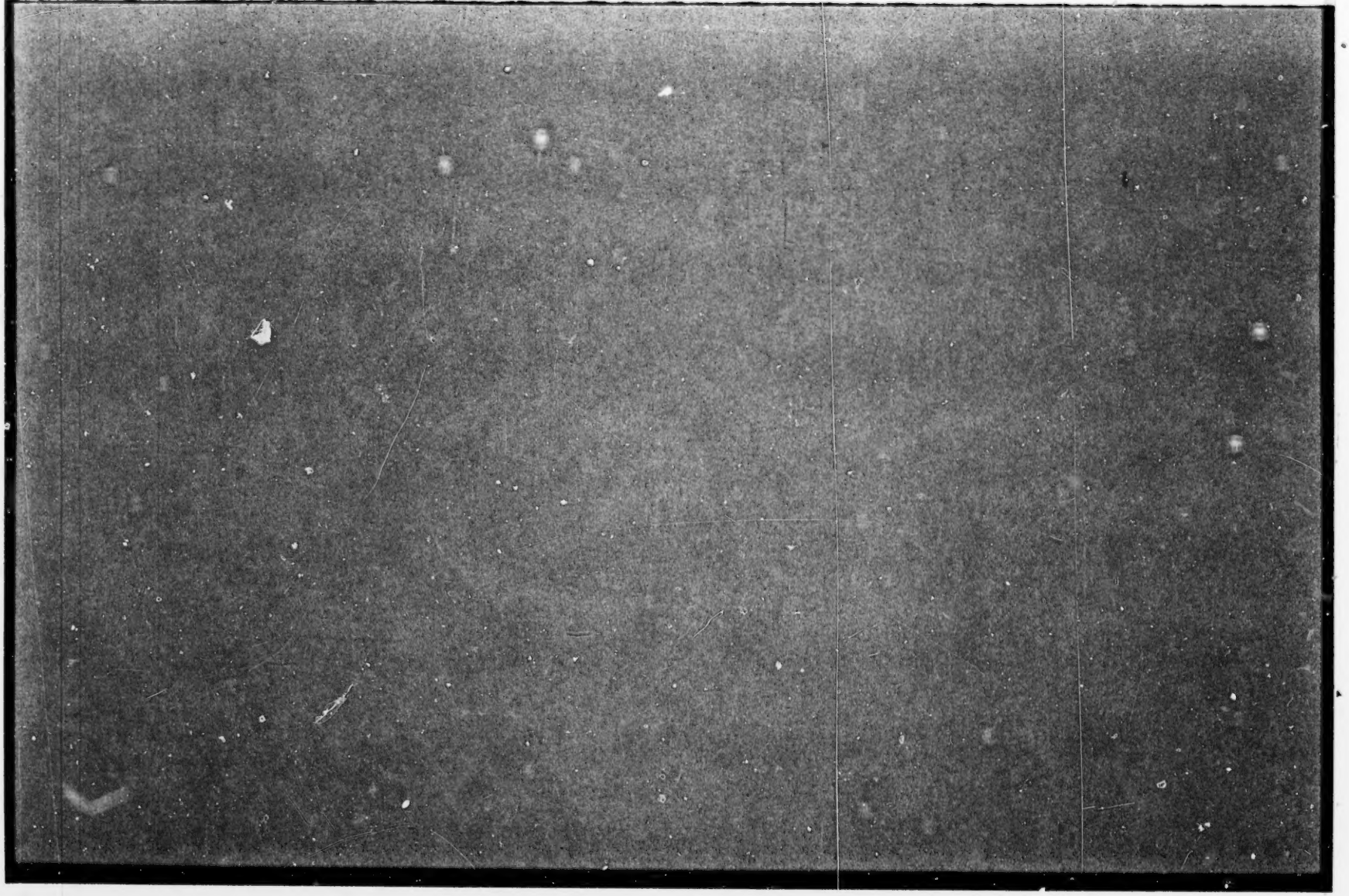
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THE FRANKLIN LIFE INSURANCE COMPANY,

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioner, The Franklin Life Insurance Company, prays that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Seventh Circuit in the above-entitled case.

## OPINIONS BELOW

The opinion of the Court of Appeals is reported at 399 F. 2d 757, and is reprinted as Appendix A hereto, pp. 1a-14a, *infra*. The District Court for the Southern District of Illinois wrote no opinion. Its extensive findings of fact and conclusions of law relative to the issues tendered hereby are set forth in Appendix D hereto, pp. 19a-50a, *infra*.

## JURISDICTION

The judgment of the Court of Appeals was entered on July 11, 1968. (Appendix B, pp. 15a-16a, *infra*) A timely Petition for Rehearing was denied on August 30, 1968. (Appendix C, pp. 17a-18a, *infra*) The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1). The basis of jurisdiction in the District Court was 28 U.S.C. § 1346(a)(1) and Internal Revenue Code of 1954, § 7422.

## QUESTIONS PRESENTED

1. Whether deferred and uncollected premiums, which a life insurance company has not received and has no right to receive, should be reflected to increase its net income ("gain from operations") under Section 809 of the Internal Revenue Code of 1954 ("Code"), as added by the Life Insurance Company Income Tax Act of 1959.

2. Whether the loading on these deferred and uncollected premiums should be included in the assets of a life insurance company under Code Section 805 for the purposes of computing the taxable share of its investment income.

3. Whether advance interest on a life insurance company's policy loans, which has not been earned within the taxable year, is properly includible in the company's investment income under Code Section 804.

4. Whether capitalized interest on policy loans, which a life insurance company has not earned within the taxable year, is properly includible in its assets under Code Section 805 for the purposes of computing the taxable share of its investment income.

## STATUTES AND REGULATIONS INVOLVED

The statutory provisions involved, Sections 801(a) and (b), 802, 804, 805(a), (b) and (c), 809, 810(a), (b) and (c), 811 and 818(a) of the Internal Revenue Code of 1954, as added by the Life Insurance Company Income Tax Act of 1959, and Sections 446(a), (b) and (c) and 451(a) of the Internal Revenue Code, are set forth in Appendix E, pp. 51a-78a, *infra*. Also set forth in Appendix E are the pertinent parts of Sections 1.809-4 and 1.818-2 of the Income Tax Regulations (pp. 78a-82a, *infra*).

## STATEMENT

Petitioner is a legal reserve life insurance company. For its taxable years commencing in 1958, it has been subject to the Life Insurance Company Income Tax Act of 1959.[1] The Internal Revenue Service ("IRS") imposed additional assessments against petitioner, on two principal bases, for the years 1958 through 1962. (App. 39-42, Tr. 128-30; App.

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[1] Internal Revenue Code of 1954, §§ 801-820, as added by Public Law 86-69, 73 Stat. 112, as amended. This legislation will henceforth be referred to as the "Act" and statutory section references not otherwise identified herein will be to the Internal Revenue Code section numbers of the Act.

The Act amounted to a "comprehensive overhaul" of the provisions of the Internal Revenue Code affecting life insurance companies. *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235 (1965). From 1921 to 1958, these companies were taxed only on a portion of their investment income. The Act introduced the concept of taxing life insurance companies on their "gain from operations," the life insurance company equivalent of "net income." It also provided a new set of formulas for allocating investment income between the portion attributable to the policyholders and the taxable portion attributable to the company. For a general discussion of the provisions of the Act, see *United States* v. *Atlas Life Ins. Co., supra,* at 235-36, and n. 2 (1965). See n. 3, p. 21, *infra.*

3-20; App. 353-56)[2] Petitioner paid the assessments and sued in the District Court for the Southern District of Illinois for a refund. The two main bases of the additional assessments and the refund suit, and the two basic questions which are tendered by this Petition, have to do (1) with the treatment of premiums deferred and uncollected as part of petitioner's taxable income and as part of petitioner's assets,[3] and (2) with the inclusion of unearned interest on policy loans in petitioner's income and assets.

1. *Treatment of Premiums Deferred and Uncollected.*— When the anniversary date for a life insurance policy occurs and the entire premium for the coming policy year has not been paid in full, the premium—or the portion thereof—for the coming year which has not been paid is called "deferred and uncollected" or, in certain cases, "due and uncollected." (App. 77, Tr. 206, pp. 31a-32a, *infra*)

There can be two reasons why the full annual premium has not been paid on the anniversary date. The first reason is that only a part of the year's premium was payable on the anniversary date, and the rest, pursuant to the terms of the policy, is payable during the course of the ensuing year on a semiannual, quarterly, or monthly basis. Under these circumstances, only the semiannual, quarterly, or monthly premium payable on the anniversary date would have been received, and the remaining portion of the year's

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[2] References to the appellant's (respondent here) Appendix in the Court of Appeals will be denoted as "App." and to the manuscript record as "Tr."

[3] The amount of petitioner's assets is relevant to one of the computations performed under the Act, namely, the determination of the shares of investment income which are allocable to policyholders, on the one hand, and to the company (and, hence, taxable), on the other. This allocation, very generally speaking, depends on the ratio of liabilities to policyholders on the one hand to total assets on the other hand. See generally §§ 804-05, pp. 56a-64a, *infra*.

premium would be "deferred and uncollected." The second reason is that the premium has become payable—sometimes loosely called "due"—in whole or in part, but that the policyholder has not paid it. As long as the policy remains in force although the premium payment is "due" and unpaid on it—as would be the case during the usual 30-day "grace periods" which are included in policies under state law or company practice—the premium in question would be "due and uncollected."[4] (App. 120-21, Tr. 9[illegible]

In either case, the insurance company has no right to collect the "deferred" or "due" portion of the premium, and in fact will never have any such right. (App. 79, Tr. 207, p. 33a, *infra*) Indeed, life insurance policy premiums never become "due" in any real sense—such as the sense that a mortgage payment becomes due. A life insurance policy is a classic example of a unilateral contract; all the legally enforceable obligations run in one direction—from the insurance company to the persons having an interest in the policy. The payment of the stipulated premiums is not a duty; it is simply a condition precedent to the life insurance company's obligations to provide coverage.

In order to comply with the requirements of the insurance regulatory authorities in the states in which it does business, petitioner makes up its financial statements on certain forms promulgated by the National Association of Insurance Commissioners ("NAIC").[5] (App. 62-63, Tr.

[4] For the remainder of this Petition, we shall generally refer to both premiums "deferred and uncollected" and "due and uncollected" as "deferred and uncollected" for the sake of brevity.

[5] The NAIC is a national organization composed of the officials of the several states who are charged with supervision of insurance companies and their operations. The NAIC was organized in 1871. Soon after its organization the NAIC adopted

183-84; App. 74-76, Tr. 204-05, pp. 28a-30a, *infra;* App. 111-13, Tr. 78-80) The statement forms prescribed by the NAIC have long[6] imposed a requirement on petitioner to take into account as a liability the coming full policy year's legal reserve[7] on all policies whose anniversary date has occurred during the calendar year ending on date of the statement. The forms also require petitioner to take as a deduction in computing its net income—or, as the NAIC statement calls it, its "gain from operations"—the amount by which its total reserve liabilities at the end of the year exceed the corresponding figure at the beginning of the year. (App. 79, Tr. 207, pp. 33a-34a, *infra;* App. 115, Tr. 83)—As indicated, these reserves include the full annual reserve increase in respect of policies on which a portion or all of the annual premium remains deferred and uncollected.

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a uniform annual statement form and related instructions, and life insurance companies have filed their annual statements since then on the forms from time to time adopted by the NAIC. (App. 74-75, Tr. 204, p. 28a, *infra*)

[6] This requirement appears in the current (1951) revision of the forms and, indeed, first appeared in 1873. (App. 119, Tr. 89; App. 338, Tr. 536) Hence, it long predates the Act.

[7] The "legal reserve" consists of "that fund which, together with future premiums and interest will be sufficient to pay future claims." *United States* v. *Atlas Life Ins. Co., supra,* at 236, n. 3. Another definition is that it consists of an amount which is computed on the basis of a recognized mortality table and assumed rates of interest which is set aside to mature or liquidate future unaccrued claims arising from life insurance and annuity policies and contracts involving life contingencies. (See § 801(b)(1), pp. 51a-52a, *infra.*) The "full year's" legal reserve is the total amount required to be added to the reserve increase with respect to a given policy in respect of that policy's continuation for the entire year subsequent to the anniversary date in question. That increase includes a full year's *net* premium—loading (see n. 9 p. 7 *infra*) is not included and plays no part whatsoever in the reserve increase. Inasmuch as this full annual amount is required by state law (see § 801(b)(2), p. 52a, *infra*), it is also included in taxpayer's liabilities for computing its taxes under the Act as of the anniversary date in question.

Obviously, this inclusion of the reserve liabilities with respect to premiums deferred and uncollected, in and of itself, would have the effect of introducing charges against the company's income and making it less than what it would otherwise have been. However, the NAIC form then proceeds to "wring" out of the income statement the effect of including these particular reserve liabilities by including an offsetting, balancing factor against them. This factor is called the net valuation premium; it consists of the *full amount* of the deferred and uncollected premiums *offset* by the so-called *"loading"* on these premiums.[8] This factor exactly balances the particular reserve liabilities in question. Thus, the net effect is exactly to cancel out the effect of including these charges against income; it is the same as if the increase in the reserve liabilities in respect of the premiums deferred and uncollected had not been included in the NAIC form as a charge against income in the first place.[9]

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[8] Since this computation is for making up the "income" or "gain from operations" account and not a balance sheet computation, what actually is done is to "wring" out the *increase* of this amount at year end over the amount at the beginning of the year. Similarly, the amount of reserves which are correspondingly "wrung" out from the debit side of the equation is the *increase* of reserves in respect of premiums deferred and uncollected as of the end of the year over the amount at the beginning of the year.

[9] As suggested, the calculation is essentially circular. The two figures which are offset against each other to produce the factor which "wrings" out the increases in reserves attributable to premiums deferred and uncollected are called (1) the "gross annual premiums deferred and uncollected," which is the whole amount of the deferred and uncollected premiums and (2) the "loading" thereon—also defined as the excess of the gross annual premium over the "net annual valuation premium."—The "net annual valuation premium," to complete the circle, is the amount of premium needed each policy year to be passed to the reserve in order to maintain the reserve. (App. 77, Tr. 205-06, pp. 31a-32a, *infra;* App. 116,

In computing its income tax, petitioner did not reflect in its net income ("gain from operations") the deferred and uncollected portion of the premiums for the coming year on policies whose anniversary date had come by the end of the taxable year.—As indicated above, these premiums had not been received, there was no right to receive them at the close of the taxable year, and some of them would not even be payable by the policyholders for as long [redacted] the NAIC form, also, these deferred and uncollected

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Tr. 84-85) Thus, the formula amount which is offset against the increase in reserves with respect to premiums deferred and uncollected in order to "wring" them out is the increase in net annual valuation premium attributable to premiums deferred and uncollected, which is derived by subtracting the applicable "loading" from the "gross annual premiums deferred and uncollected." As is evident, this circular computation simply takes one back to where he would be if the reserve liabilities with respect to premiums deferred and uncollected had not been included as a deduction from income in the first place. Quite understandably, this procedure has been criticized as "unnecessarily clumsy. A much simpler method and one that would be more intelligible to the general public would be to deduct the aggregate amount of the actuarial net premiums (which were uncollected and deferred) directly from the aggregate amount of reserves calculated according to the established method before entering the reserve liability in the Annual Statement." Wightman, *Life Insurance Statements and Accounts* (1952), pp. 45-46.

The computation may be illustrated by reference to certain of the lines in the NAIC form, a copy of which is in the record as Jt. Ex. 25. The NAIC form (page 4, "Summary of Operations") takes as a deduction the entire increase in the legal reserve, including the portion attributable to premiums deferred and uncollected (line 17). Against this are offset as a positive item the gross amount of premium income accrued, *plus* the increase in the gross amount of premiums deferred and uncollected (line 1) and as a negative item the increase in loading on premiums deferred and uncollected (line 25). The net effect is thus to cancel out the factor, included as a charge against income, for the increase in reserve liabilities with respect to premiums deferred and uncollected.

premiums are not reflected in petitioner's gain from operations.[10]

Nonetheless, the IRS required petitioner to reflect in its income for each taxable year the full amount of deferred and uncollected premiums. The IRS thus required petitioner to pay a tax based on the assumption that the *gross* amount—including loading—of these deferred and uncollected premiums had in fact been received on the anniversary date of the petitioner's policies.

Similarly, in computing petitioner's assets for one of the special computations applicable to Federal income taxation of life insurance companies—a computation in which an increase of assets as compared to liabilities to policyholders would result in increasing petitioner's taxes[11]—the IRS required petitioner to include as an asset the gross amount of the deferred and uncollected premiums with respect to policies whose anniversary dates had occurred during the taxable year.—In its computation of its assets and liabilities petitioner had followed state insurance law and the NAIC form; these require petitioner to include as a liability the full annual legal reserve on all its policies for the year following their anniversary date—including the portion relating to deferred and uncollected premiums

[10] The only real issue with respect to this aspect of the matter is whether the "increase in *loading* on premiums deferred and uncollected" is to be included in income. The inclusion of the net valuation premium is immaterial, since it simply cancels out the charge for the reserve in respect of premiums deferred and uncollected, and does not cause any plus or minus reflection of premiums deferred and uncollected in net income ("gain from operations"). Thus, it is appropriate to characterize the issue in question either as being whether premiums deferred and uncollected should be reflected in the taxpayer's net income, or whether the increase in loading on such premiums should be included in the taxpayer's income.

[11] See n. 3, p. 4, *supra*.

—and to include as an offsetting asset the amount of deferred and uncollected premiums net of loading (the so-called "net valuation premium").[12] This offsetting asset is in an amount which exactly cancels out the liability attributable to the legally-required inclusion in the reserves of that portion of the reserves attributable to premiums which were deferred and uncollected at year end. (App. 85-86, Tr. 211-12, pp. 40a-41a, *infra;* Jt. Ex. 25, pp. 2-3; App. 129-30, Tr. 103-04)

2. *Unearned Advance Interest on Policy Loans.*—Those of petitioner's life insurance policies which have cash values provide that a loan may be made upon the sole security of the cash value of the policy. The policies provide for the payment of interest on these loans—generally at the rate of five percent—payable annually in advance. If the policyholder repays the loan before the end of the year for which interest has been paid (or if his policy terminates at maturity or by death, causing a liquidation of the loan by an offset against the policy proceeds), the unearned portion of the interest is credited to him pro rata. (App. 88, Tr. 214, pp. 43a-44a, *infra;* App. 269-70, Tr. 391-92)

When a policyholder who has a loan does not pay interest thereon when due—for example, the annual advance interest payable at the beginning of the second year of the loan —the amount of the year's interest not paid is added[1] to the principal of the loan. (App. 280, Tr. 405-06; App. 91, Tr. 216, p. 46a, *infra*) However, if the loan is repaid or otherwise retired before the end of the year for which the capitalized interest has been added to the policy loan, the

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[12] See n. 9, p. 7, *supra.*

[1] If the cash value of the policy will support it.

pro rata share of the unearned interest so capitalized is credited to the policyholder. (App. 91, Tr. 216, p. 47a, *infra*)

Petitioner included in income only that portion of advance policy loan interest which was in fact earned during the taxable year. Thus, in the case of a policyholder charged $50 annual interest on July 1 with respect to [redacted] of the interest would be earned by December 31, and if the loan were repaid on that date, the other $25 would have to be credited to the policyholder. Accordingly, petitioner would only include $25 in income with respect to the policy loan interest for the year indicated. Similarly, in the case of capitalized interest added to the principal of a policy loan balance, petitioner included in its assets, for the purposes of the computations under the Act to which asset amounts are relevant, only the portion of the capitalized interest which had been earned by the year end. Both these aspects of the treatment of advance interest agreed with the accrual method in which petitioner regularly kept its books and with the treatment given the items in question in the NAIC forms.[2] (App. 91-92, Tr. 216-17, pp. 46a-48a, *infra*)

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[2] The computation is made in Exhibit 3 to the NAIC form. Line 5 of this Exhibit relates to "interest on premium notes, policy loans and liens"; actually, the only significant item currently reported in this line is "interest on . . . policy loans". From the amount "collected during the year" (column 1) is subtracted the "unearned" amount (column 2) and to the remainder is added the amount due at the close of the year (column 3). After appropriate adjustments for the previous year's interest, the remaining amount is the amount "earned during year" which is then passed to Exhibit 2, together with the total of other items of investment income, for the subtraction of appropriate expenses and the computation of net investment income, which is, in turn, transferred to line 4 of the Summary of Operations as "net investment income."

Nonetheless, the IRS assessed a deficiency against petitioner. The IRS took the position that petitioner should include in income the entire amount of interest received in advance in the year in which it is received, notwithstanding that a portion of it was not earned during the year in question and would have to be paid back if the loan were paid off. It also took the position that petitioner should include the full amount of capitalized policy loan interest in its assets, notwithstanding that a liability existed to credit the unearned portion of this sum back.

* * * * *

After the receipt of stipulations and a full evidentiary hearing, the District Court held for petitioner on both sets of issues. It held that inasmuch as petitioner had no legal right to collect deferred and uncollected premiums, the increase in loading on deferred and uncollected premiums should not be included in taxable income and the loading should not be included as an asset. (App. 82, 84, 85-87, Tr. 209, 211-13, pp. 36a-37a, 39a-43a, *infra*) It also held that inasmuch as the advance interest was earned only ratably day by day, and since the policyholder had the right to pay off a policy loan at any time and receive a refund of the unearned interest pro rata, the advance interest paid or capitalized on policy loans should not be included in petitioner's income or assets until earned. (App. 88-94, Tr. 214-18, pp. 43a-50a, *infra*) Judgment was entered in favor of petitioner for a total of $1,303,011 in taxes and interest, of which $1,249,184 represented the taxes and interest relating to the issues stated above.[3] The respondent appealed from the judgment of the District Court to the Court of Appeals for the Seventh Circuit with

[3] Certain other issues raised by the complaint were settled by the parties and included in the judgment or were determined by the District Court and not appealed by the respondent.

respect to the issues stated above, and the Court of Appeals reversed the judgment of the District Court on these issues.

## REASONS FOR GRANTING THE WRIT

### A. *The Issues Respecting Premiums Deferred and Uncollected*

1. *The Questions Are Substantial.*—By the decision of the court below, for what is believed to be the first time in the history of the Federal income tax laws, amounts which a taxpayer has not received and which he has no right to receive have been included in his income and he has been made to pay a tax on them. Previously, under settled principles of tax accrual accounting, it had been uniformly considered that inclusion of an amount in income takes place only upon the earlier of the arising of the right to receive it or the actual receipt of it. See *Schlude* v. *Commissioner,* 372 U.S. 128, 133 n. 6, 136-37 (1963), and cases cited; *Commissioner* v. *Hansen,* 360 U.S. 446, 463-64 (1959). The decision of the court below goes far beyond what has been judicially considered income,[1] and its reasoning is completely without support in the text or history of the statute or in the settled principles of tax accrual accounting.

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[1] The ruling also goes beyond the concept of "income" in popular speech—and hence, the concept of income in the Constitution, whose Sixteenth Amendment uses the word "income" in the popular sense. See *Eisner* v. *Macomber,* 252 U.S. 189, 206-07 (1920). This question presented in the case—as did the question in *United States* v. *Atlas Life Ins. Co.,* 381 U.S. 233 (1965)—accordingly raises issues of Constitutional significance. See the Government's Petition for Certiorari in the *Atlas Life* case, pp. 12-15, where it was pointed out that in the context in which the question involved in that case arose, the statutory and Constitutional questions coalesced. The *Atlas Life* petition is believed to be the only petition for certiorari involving an issue under the Act tendered to this Court prior to this one. Certiorari was granted.

The ruling of the court below requires the gross amounts of premiums deferred and uncollected, including loading, to be reflected in income; and of course it requires they be taken into account without deduction for commissions and other expenses chargeable against that loading, since those commissions and other expenses have not yet accrued and will not accrue until the premiums are paid.[2] In the light of the industry-wide experience (see pp. 20-22, below) of substantial annual increases in loading on premiums deferred and uncollected—with the corresponding expenses not incurred until the year in which the premium is actually received—the decision below will have the effect of making a permanent overstatement of the real income of life insurance companies.

The holding of the court below finds no support in the text of the statute. The Act requires the inclusion in income of:

> "Premiums.—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto) . . . ." (Section 809(c)(1), p. 67a, *infra*.)

The statute expressly includes advance premiums, and makes no mention of premiums deferred and uncollected. Against the backdrop of tax accrual accounting required as to life insurance company taxation (see Section 818(a), p. 77a, *infra*), it is clear that this statutory language includes only the gross amount of premiums which the tax-

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[2] The petitioner's position is simply that premiums should be reflected in income when received and the related deductions for commissions and the like then taken.

payer has received during the course of the year or those (if any)[3] with respect to which its right to receipt matured during the year. Premiums, after all, are the amounts paid for life insurance coverage. There is not a word of support in the legislative history—and neither the court below nor the respondent in arguing before it pointed to any—for reflecting in income deferred and uncollected premiums—premiums which the taxpayer has not received and has no right to receive and for which it has not yet provided coverage.

The only support in the authorities for the holding of the court below was the IRS' own regulation, promulgated in 1961, which reworked the provision of the statute quoted above by inserting in it the words "premiums deferred and uncollected and premiums due and unpaid." See Regulations 1.809-4(a)(1)(i) p. 79a, *infra*.[4] As indicated below (pp. 24-25 and nn. 13 and 14, pp. 24 and 25), the promulgation of that regulation simply created the industry-wide controversy with the IRS as to which this case furnished the first appellate adjudication.

The holding of the Court of Appeals is apparently based on three assumptions: *First,* that the taxpayer had con-

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[3] There are evidently a few unusual forms of life insurance policies, in the group area, which do give rise to an account receivable when the premium becomes "due." See Nash, *Taxation of Life Insurance Companies* (1968), § 17.04. This form of policy is not involved in this case; only the conventional policy on which payment of the premiums never amounts to a legal obligation.

[4] Thus, the regulation provides that the term "gross amount of all premiums" "includes advance premiums, *premiums deferred and uncollected and premiums due and unpaid,* deposits, fees, assessments and consideration in respect of assuming liabilities under contracts not issued by the taxpayer. . . ." The italicized words are the words which the IRS added to the statutory language quoted in the text at p. 14 above.

ceded a keystone point in the case (see p. 7a, *infra*); *second,* that the taxpayer was contending for a *deduction* for the loading on premiums deferred and uncollected, a deduction no provision for which the court found in the statute (see p. 7a, *infra*); and *third,* that the basic issue in the case was whether the NAIC form was somehow sacrosanct and took precedence over the principles of Federal tax law which might have been thought otherwise to apply.[5] (see pp. 6a-7a, *infra*)

These three assumptions are all manifestly erroneous. —In the first place, petitioner has never taken any position other than that Section 809 does not require the inclusion in gross income of deferred and uncollected premiums.[6]

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[5] The court below also apparently accepted (see pp. 7a-9a, *infra*) the respondent's argument that inasmuch as, on the debit side of the petitioner's statement of operations, the reserve increase relating to premiums deferred and uncollected is taken into account, as required by state law (and hence by Section 801(b)(2)), it was somehow only fair to take into account the gross amount of the premiums deferred and uncollected as an income item, although there was no right to receive them.—The Government conceded in the court below that if it were not for the inclusion of the reserve liabilities, the premiums deferred and uncollected could not be taken into income. (Gov't Br., p. 35)

But this argument is clearly incorrect. As indicated above (p. 7), the petitioner (and the NAIC statement form) proceed precisely to cancel out the inclusion of the reserves allocable to premiums deferred and uncollected by making a balancing entry of the allocable net valuation premium on the credit side of the equation. If it is supposedly fair, because the reserve has been included for computational purposes, to include the gross premium deferred and uncollected in income (even though under accrual principles its inclusion would admittedly be unthinkable), the respondent never has pointed out why it would not also be just as fair to introduce the unaccrued related expenses involved in collection, commissions, and the like, with respect to the gross premiums deferred and uncollected. For it is only "[A]s the deferred premium is collected in gross, [that] expenses are accrued in relation thereto and income and profit is reflected." Nash, *Taxation of Life Insurance Companies* (1968), § 17.06, at p. 17-11.

[6] See the Petition for Rehearing below, pp. 1-2.

Secondly, the court below erred when it characterized the issue here as whether there was a statutory deduction for increase in loading on deferred and uncollected premiums.[7]—The court, quite understandably, failed to find any such express deduction; of course, the reason is that Congress never contemplated that such an amount—which the taxpayer neither has received nor has the right to receive—would be reflected in income in the first place. As indicated above, there is not a shred of support in the statute or the legislative history for the inclusion of such an amount in income; and under any principle of tax accrual accounting its inclusion would be unthinkable.[8]

Thirdly, the Court of Appeals erroneously assumed that the basic question in issue was whether the NAIC form, or tax accrual accounting, was governing. But the fact of the matter is that under *no* concept of tax accrual accounting have items such as those at issue here ever been included in gross income before or can they be so included. The further, and paradoxical, fact is that it was the court below, not petitioner, which was led astray by the peculiarities of the NAIC form. The court labored under the misconception that use of the formula which the NAIC follows in order to "wring out" of income the

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[7] The District Court did not find that what was involved here was a deduction, but simply a question of the proper amount to offset against the reserve liabilities. See Conclusion of Law 2, App. 84, Tr. 211, p. 39a, *infra*.

[8] If, however, it could be said that the gross premiums deferred and uncollected were somehow accruable and includible in income, it would appear that there would be a statutory deduction for the loading on them. That deduction is the deduction provided life insurance companies for reserves for unearned premiums. See Section 810 (c) (2), p. 75a, *infra*. However, we of course need not go this far; the basic position of petitioner is simply that it is improper to reflect premiums deferred and uncollected in net income at all by taking the loading on them into income.

effect of including the reserve requirements in respect of premiums deferred and uncollected—the offsetting of the gross amount of premiums deferred and uncollected against the applicable loading to produce a net figure to cancel the effect of including the reserve liabilities for those premiums (see p. 7, *supra*)—somehow amounted to an attempt to take a deduction unauthorized by law. But, as developed above, this case does not involve the question whether the NAIC form can authorize a deduction not contemplated by Congress, but the question whether the loading on premiums deferred and uncollected is includible in income in the first place.[9]

The decision of the Court of Appeals, accordingly, on this issue is so lacking in authority, so manifestly without support in the statute, and so patently out of line with normal tax accrual accounting principles, as to suggest the need for review by this Court—even apart from the fact, as we develop at pp. 20-29, below, that the issue involved is of enormous industry-wide importance.

Similarly questionable is the Court of Appeals' related holding that the gross amount of deferred and uncollected premiums, including loading, was includible in petitioner's assets for calculating the policyholders'-liabilities-to-assets ratios which figure in the computation of certain

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[9] The only secondary, let alone primary, authority cited by the court below in support of its conclusion is a passage from Wightman, *Life Insurance Statements and Accounts*. See p. 8a, *infra*. But an examination of the pages cited makes it clear that what the court below was referring to was the recommendation of an industry committee that these amounts be treated as accrued income and assets, which recommendation the NAIC rejected; and, in Wightman's view, correctly. See *id.*, at p. 45. The conclusions of Wightman's treatise are in accord with our position. Thus, he indicates (p. 374) that inclusion of the loading on deferred and uncollected premiums in income would amount to an overstatement of income. See also n. 9, p. 7, *supra*.

aspects of petitioner's income taxes. The Tax Court has recently decided this very issue in flat conflict with the decision of the Court of Appeals. *Western National Life Ins. Co.*, 50 T.C., No. 28, May 13, 1968, CCH Tax Ct. Rep. ¶28,954. As the Tax Court trenchantly observed:

> "The ready and simple answer to whether these items can be 'assets' is that they have no existence as an asset . . . There being no liability upon the policyholders to make any premium payments, there can be no justification for their accrual. Absent an accrual in this situation, only resort to mediaeval metaphysics could translate the items in question into 'assets'." CCH Tax Ct. Rep., at p. 2427.

The Court of Appeals did not, as to its inclusion of these items in assets, have even the benefit of its erroneous assumption that the exclusion of these items somehow involved an unauthorized deduction. The NAIC form itself on this point does not go through the two-step process—which apparently confused the court with respect to the issue of inclusion in income—of netting the loading against the gross amount of premiums deferred and uncollected in order to produce the number which will "wring out" the reserve liabilities with respect to the premiums deferred and uncollected. (See pp. 7, 9-10, 17-18, *supra*) The form simply includes directly the net valuation premium on the premiums deferred and uncollected—the amount net of loading—in order to match and cancel out the reserve liability on the premiums deferred and uncollected.

The approach of the IRS here, sanctioned by the court below, requires the inclusion in assets of the gross premiums deferred and uncollected, which have not been

received and which are not receivable, notwithstanding that simultaneously upon the receipt of these premiums they will be burdened by liabilities, such as commissions payable, which will match them in whole or in part—liabilities which the petitioner is, of course, not permitted to accrue. Here again, the Court of Appeals' decision, even apart from its overwhelming importance to the industry, is so absolutely without foundation in authority and so out of line with normal tax accrual principles as to warrant this Court's review.

2. *The Questions Are of Great Public Importance.*—(*a*) The Court of Appeals held, in effect, that the annual increase in loading on deferred and uncollected premiums must be included in the net income of life insurance companies. The figures published by the Institute of Life Insurance of the amounts reflected for this increase in loading item[1] on the annual statements of all the approximately 1,200 life insurance companies in the United States which reported to it[2] were, for the three most recent years for which figures are available, as follows:

| *1964* | *1965* | *1966* |
|---|---|---|
| $52,600,000 | $76,200,000 | $84,600,000 |

[1] The item in question is a line item in the NAIC form. (Jt. Ex. 25) See n. 9, p. 8, *supra*. Line 25 of the "Summary of Operations" of the NAIC form is captioned "Increase in Loading On and Cost of Collection in Excess of Loading On Deferred and Uncollected Premiums." The Institute of Life Insurance collects and publishes industry-wide figures for the various line items in the Summary of Operations and Statements of Assets and Liabilities in the NAIC form.

[2] There are approximately 1,700 life insurance companies in the United States. Institute of Life Insurance, *Life Insurance Fact Book* (1968), p. 95. However, the approximately 1,200 companies reporting to the Institute of Life Insurance are believed to account for virtually all of the companies writing any active volume of business.

These amounts, accordingly, on the IRS' theory, adopted by the Court of Appeals here, would be includible in income to the industry as a whole for the years in question if the opinion of the Court of Appeals is followed. We believe that it is the position of the entire industry that such amounts are not properly includible in income and that virtually the entire industry has taken this position in computing its income taxes under the Act. (See the responses to questionnaires discussed at pp. 27-28, *infra*)

We do not mean to imply that the annual amount of the tax effect of this aspect of this issue on the industry as a whole may be determined simply by applying the corporate tax rates to the above figures.[3] Thus, because they are "owned" by their policyholders and accordingly tend to pay out substantial amounts to them, the mutual life insurance companies, by taking advantage of the deduction for policyholder dividends, tend in

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[3] As indicated above (n. 1, p. 3), the basic approach of the Life Insurance Company Income Tax Act (see generally Section 802(b), p. 55a, *infra*, and the discussion in the *Atlas* case, 381 U.S., *supra*, at 235-38) is to impose a tax at the ordinary corporate rates on the sum of:

1. Taxable investment income (that is, the so-called "company's share," as contrasted with the "policyholders' share," of investment income) or, if smaller, the gain from operations (but for this purpose there are not permitted as deductions from the gain from operations dividends paid to policyholders and certain other special deductions to the extent that the same would cause the gain from operations to be reduced below a "floor" of taxable investment income less $250,000) (Section 809(f), p. 73a, *infra*); plus

2. If gain from operations (computed with the full deduction for dividends paid to policyholders) exceeds taxable investment income, an amount equal to 50 percent of such excess; plus

3. The amount withdrawn from the policyholders' surplus account for the taxable year. Generally speaking, the "policyholders' surplus account" consists of the initially untaxed 50 percent of the excess of gain from operations over taxable investment income, plus certain other amounts, including the special deductions referred to in item 2, above. (Section 815(c))

many cases not to have an excess of gain from operations over taxable investment income.[4] For the reasons just stated in the margin, this tends to diminish the impact of the inclusion of the loading on premiums deferred and uncollected on them. However, even excluding *all* mutual companies, the estimated[5] industry-wide totals for *stock company* members reporting to the Institute of Life Insurance, of the increase in loading on deferred and uncollected premiums in any given year, still yields a most substantial rock-bottom figure. These estimated figures for the three years are as follows:

| *1964* | *1965* | *1966*[6] |
|---|---|---|
| $11,200,000 | $16,200,000 | $18,000,000 |

The annual amount at stake on this aspect of the deferred and uncollected premium issue thus appears to lie somewhere between the maximum and minimum figures set forth above.

(*b*) There is more; namely, the effect of the inclusion of the loading on the deferred and uncollected premiums

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[4] See Harman, *The Pattern of Life Insurance Company Taxation Under the 1959 Act,* 15th Ann. Tulane Tax Instit. 686, 719 (1965).

[5] The estimate has been prepared by taking the industry-wide figure and dividing it between mutual companies and stock companies in the ratio indicated by an individual analysis of the hundred largest U. S. companies. These hundred companies in and of themselves account for approximately 85% of the industry-wide figures.

[6] Since most of the stock companies have a gain from operations in excess of their taxable investment income, it would follow that, generally speaking, 50 percent of the amounts indicated above for the years in question would be immediately taxable to them at the ordinary corporate rates—even if no amounts were taken into account for the mutual companies—and the remaining 50 percent would be taxable at the ordinary corporate rates to the extent it was ultimately distributed to the stockholders, and under certain other circumstances.

as an *asset*. This inclusion, ordered by the court below, affects *all* life insurance companies, mutual and stock alike. This is because the amount of the assets of the companies, taken as a comparison with their liabilities to policyholders, is used to determine the portion of their investment income taxable as the "company's share." The amount taxable as taxable investment income is not (as is the amount of gain from operations taxable as such) subject to reduction (other than in a nominal amount) by dividends paid to policyholders;[7] and accordingly, mutual companies are as much affected by this question as are the stock companies.

Here, the figures are of staggering size. It is estimated that for the industry as a whole the total amount of loading on premiums deferred and uncollected as of December 31, 1966, the latest date for which pertinent statistics are available, is $830,000,000.[8] In their annual statements,[9] as well, it is believed, as in their computations for tax purposes,[10] the 1,700 life insurance companies in the United States do not include this amount in their assets.

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[7] See n. 3, p. 21, *supra*.

[8] To derive this figure, the published industry-wide figure of $3,269,000,000 of net due and deferred premiums as of December 31, 1966, was first taken. A study of the hundred largest U. S. companies (which in themselves accounted for 85% of this figure) was made, which indicated the ratio between the loading on the due and deferred premiums (shown as line 17 of Exhibit 13 on the NAIC forms for these companies) and the net due and deferred premiums. This ratio was then applied to the published industry-wide figure.

[9] As indicated above (pp. 9-10), the NAIC form shows the figure for the premiums deferred and uncollected on the basis of the net valuation premium, that is, net of loading. See line 17 of the table of "Assets" in the form (Jt. Ex. 25); see line 17 of Exhibit 13 to the NAIC form, which separately displays the excluded loading and the amount carried to line 17 on the Assets table.

[10] See Schmuck, *Current Problems in Insurance Company Taxation Under the 1959 Act*, 15th Ann. Tulane Tax Instit. 759, 772-73

The effect of the decision of the court below is to require the inclusion *annually* of this enormous amount, not representing any item received or receivable—and of course without any offsetting liability for related costs[11]—in the assets of life insurance companies, and thereby to create a great proportionate increase in the amount of their investment income which is allocable to the taxable "company's share."

(*c*) Moreover, just the few years covered by the foregoing tabulations and figures fall far short of telling the entire story with respect to the importance of this issue. For the well-known fact of the matter is that in the life insurance industry, very few taxable years even commencing on January 1, 1958, the effective date of the Act, and for very few companies, are now "closed" for income tax purposes.[12]

From the earliest days of the Act, a number of controversial industry-wide issues were apparent. The regulation in question, purporting to include in income and assets loading on premiums deferred and uncollected, was promulgated in 1961 and was immediately controversial.[13] The question of the includibility of these items was quickly recognized as one of the basic "national" issues

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(1965). See the responses to questionnaires discussed at pp. 27-28, *infra*.

[11] See pp. 19-20, *supra*.

[12] See Schmuck, *supra*, n. 10, p. 23, at 760-61; see n. 15, p. 25, *infra*.

[13] See Simon, *New Regulations on Insurance Companies Take Doubtful Position*, 14 J. Taxation 114, 116 (1961); *Report of Joint Advisory Committee on Interpretation of Company Federal Income Tax Law*, 1961 Proc. Legal Section, ALC, 330, 332.

affecting the vast majority of life insurance companies.[14] The presence of the unresolved "national" issues, such as the ones involved in this case, has greatly slowed down the "closing" of taxable years for the life insurance companies,[15] and has had the further undesirable effect of leaving substantial numbers of other issues in those years unsettled. Of course, the basic questions as to treatment of deferred premiums will affect future years' returns and audits until resolved.

For the reasons just touched on, it is believed that the issues involved in this case are, if anything, of greater public importance than those involved in *United States* v. *Atlas Life Ins. Co., supra,* where this Court granted certiorari on the only petition for certiorari under the Act presented to it prior to this case. As were the issues in *Atlas,* the issues respecting premiums deferred and uncollected in this case

[14] On October 1, 1963, the American Life Convention and the Life Insurance Association of America submitted eight major issues, which had been raised generally on the initial audits under the Act, to the national office of the IRS. See Schmuck, *supra,* n. 10, p. 23, at 759. Among them were the issues as to premiums deferred and uncollected. These issues, "for some companies, involve potential tax deficiencies exceeding substantially the amount involved in all other issues arising under the 1959 Act." *Id.,* at 771.

[15] Thus, after the submission of the ALC-LIA presentation referred to in the preceding footnote, the national office of the IRS sought to formulate a position by requiring agents to submit issues for "technical advice." "In the meantime, [i.e., in March 1964] it directed that tax audits of life insurance companies be held in abeyance—audits in many cases raising issues involving millions of dollars for a single company and creating great uncertainty about the correct figures to be used as the starting point for tax returns for subsequent years." Schmuck, *supra,* n. 10, p. 23, at 760. Because resolution of the issues was slow, "most life insurance companies have given successive waivers of the statute of limitations, keeping open their tax returns since 1958." *Ibid.* Indeed, the "freeze" on audits was not lifted until May 10, 1967. Johnson, *1967 Report on Federal Legislation and Regulation,* 1967 Proc. Legal Section, ALC, 252, 260.

are of relevance to virtually all taxable years for virtually all life insurance companies. Like the issues in *Atlas*, these issues are among the relatively few basic "national" issues arising under the Act. The Court in *Atlas* granted certiorari on the representation by the government that the decision below involved approximately $400,000,000 in taxes for prior, open years.[16] The figures which we have indicated above lead to the inference that amounts of at least this order of magnitude would be involved in the instant case for all the open years for the industry as a whole. Petitioner's size is only about one-half of one percent of the industry as a whole.[17] For only five taxable years, the amount at stake for petitioner was, as calculated in the District Court, with respect to the issues as to deferred and uncollected premiums, $873,740.—As indicated above, the "asset" aspect of the "premiums deferred and uncollected" questions is common to all life insurance companies and the "income" aspects are believed to be primarily applicable at least to the stock companies. The potential tax deficiencies involved are thus enormous.

(*d*) In *Atlas*, the petition also stressed the volume of litigation threatened by the decision. An estimate of 8,000 claims for various past years was made.[18] The issues involved here are at least as broadly applicable to life insurance companies as the issues in *Atlas*. An increasing number of "open" years since the effectiveness of the Act have ensued with the passage of time for the companies—many now have ten "open" years. Thus, it is believed that

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[16] Petition for Certiorari, p. 16.

[17] The assets of United States life insurance companies as a whole were approximately $177,400,000,000 as of December 31, 1967. *Life Insurance Fact Book* (1968), *supra*, p. 63. Petitioner's assets accounted for only $1,024,000,000 of this.

[18] Petition for Certiorari, p. 17.

an even greater number of deficiency assessments against the 1,700 life insurance companies in the United States is implicit in the issues involved here than the 8,000 claims cited in *Atlas*.

The process of auditing life insurance company tax returns has been a slow one—interrupted by a suspension of audits for several years while the IRS' position on certain national issues was resolved at the national administrative level.[19] Yet there is a substantial body of litigation on these issues already pending in court. The cases pending are set forth in the margin.[20] Moreover, the re-

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[19] See the discussion at n. 15, p. 25, *supra*.

[20] The following are the twenty-four cases other than this one known to be pending:

*Alaska Western Life Ins. Co.*, Tax Court, No. 3135-68;
*Allstate Life Ins. Co.*, Tax Court, Nos. 1622-66 and 5414-67;
*American Fidelity Life Ins. Co.*, Tax Court, No. 4469-63;
*Atlantic and Pacific Life Ins. Co.*, Tax Court, No. 2682-67;
*Bankers National Life Ins. Co.*, Tax Court, No. 655-68;
*Columbus Mutual Life Ins. Co.*, Tax Court, No. 1540-68;
*Equitable Life Ins. Co. of Iowa*, Tax Court, No. 4701-68;
*Eureka Life Ins. Co.*, Tax Court, No. 4513-68;
*Farmers & Bankers Life Ins. Co.* v. *United States*, D. Kan., No. W-3977;
*Globe Life Ins. Co.* v. *United States*, N.D. Ill., Civil No. 67-C-1991;
*Great National Life Ins. Co.* v. *Campbell*, N.D. Tex., C. A. No. 3-441;
*Heart of America Life Ins. Co.*, Tax Court, Nos. 3937-64 and 2458-67;
*Jefferson Standard Life Ins. Co.* v. *United States*, 272 F. Supp. 97 (M.D.N.C. 1967), *appeals pending*, 4th Cir., Nos. 12,326 to 12,328;
*Kentucky Central Life Ins. Co.*, Tax Court, No. 5290-67;
*Lamar Life Ins. Co.* v. *United States*, S.D. Miss. Civ. Nos. 4247 and 4248;
*National Farmers Union Life Ins. Co.* v. *United States*, D. Colo., Civ. No. 9415;
*National Life and Accident Ins. Co.* v. *United States*, M.D. Tenn., Civ. No. 4995;
*Occidental Life Ins. Co. of California* v. *United States*, C.D. Cal., Civ. No. 66-273-F;

sponse to a questionnaire circulated to the membership of the American Life Convention[21] in connection with the preparation of this Petition indicated, that of the 169 companies responding to the questionnaire, the IRS has already administratively questioned 153 or 91% of the companies' treatment of the loading on deferred and uncollected premiums, and that in 75% of the cases where questions have been raised deficiencies have already been assessed with respect to one or more years. Thus, in the light of the universal nature of this question in the life insurance industry, it may be expected that much more litigation is soon to be generated, and that if this Court authoritatively resolves the issues now, a guide will be furnished for the disposal of all these cases.

These issues have already caused more than seven years of extreme uncertainty—ever since the IRS regulations were promulgated—to the life insurance industry. That uncertainty should not be permitted to continue. The potential for litigation inherent in these issues, the uncertainty which will prevail until their resolution, the large amounts of taxes for many years involved, and the already apparent

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*Ohio State Life Ins. Co.*, Tax Court, No. 5971-67;
*Old Line Life Ins. Co.* v. *United States*, E.D. Wis., No. 68-C-149;
*Old Security Life Ins. Co.*, Tax Court, Nos. 4239-64 and 394-68;
*Security Benefit Life Ins. Co.* v. *United States*, D. Kan., No. T-4444;
*Washington National Ins. Co.*, Tax Court, No. 3057-68;
*Western Life Ins. Co.*, Tax Court, Nos. 5202-65 and 6150-65.

[21] The American Life Convention comprises approximately 350 life insurance companies which are, generally speaking, the larger companies in the industry. Both stock and mutual companies are included in the American Life Convention's membership.

large backlog of cases at the judicial and administrative levels, together with the conflict in decisions which has already arisen,[22] all unite to indicate the need for a speedy resolution by a grant of certiorari.

### B. *The Issues Respecting Unearned Interest on Policy Loans*

1. *The Questions Are Substantial.*—The Court of Appeals held that inasmuch as petitioner had received the prepaid policy loan interest "under a claim of right" and "without restriction as to its use" it had realized income in the full amount of the interest, even though the interest was only earned day by day thereafter. (p. 12a, *infra*) But this clearly is an overly simplistic view of the law on the subject. For example, a taxpayer borrowing money from a bank pursuant to an antecedent credit agreement receives the money under a claim of right and without restriction as to its use. The proceeds of the loan, however, are not income for the obvious reason that there is a fixed and determinable liability to pay an equivalent amount of money back. And so in this case; petitioner was subject to a liability to refund the unearned interest; the amount of that liability diminished pro rata every day, as the interest was earned; and it is only as that liability diminished that the interest can be said to be income.

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[22] As indicated above, on the "asset" issues involved in the questions with respect to premiums deferred and uncollected, there is already a flat conflict between the decision below and the decision of the Tax Court in *Western National Life Ins. Co.*, 50 T.C., No. 28. See p. 19, *supra*. To the same effect as the holding below is *Jefferson Standard Life Ins. Co.* v. *United States*, 272 F. Supp. 97 (M.D.N.C. 1967), *appeals pending*, 4th Cir., Nos. 12,326 to 12,329.

The court below apparently conceived that it was acting under compulsion of this Court's decisions in *Schlude* v. *Commissioner*, 372 U.S. 128 (1963) and *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961). (See pp. 12a-13a, *infra*) But those cases did not involve a countervailing liability, which was only abated pro rata with the passage of time, on the part of the taxpayer to refund the advance amounts. The cases involved the receipt of annual membership fees in advance (*Automobile Ass'n*) or the actual receipt of money for dancing lessons in advance (*Schlude*) where the taxpayers had no liability for the making of a refund whatsoever and where the services to be performed were not to be performed at any specific or ascertainable times, but on demand, within contract limits, at the option of the member or subscriber. See 372 U.S., at 135-36.

The respondent conceded below (Brief, pp. 46, 49) that the taxpayer's measurement of interest income as "unearned" and "earned" was regularly and solidly done and based on solid accounting principles. But the court below treated this fact, and the petitioner's unquestioned liability to refund unearned interest, as irrelevant inasmuch as the petitioner had originally received the sums in question under a "claim of right." But the very point of the decisions in *Schlude* and *Automobile Ass'n* was that the taxpayers there had no liability to make a refund and they could not demonstrate any solid basis for the method in which they treated the prepaid sums as "earned" or "unearned"; there was no relationship between the services rendered by them and the rate at which they treated the moneys as earned.

In contrast, the sums involved here were subject to a precise refund obligation, which scaled downwards from

day to day, and were in respect of a "service"—the loan or forbearance of money—which has historically been measured in value on a daily basis. The case is thus on all fours with the motor vehicle finance cases, *Gunderson Bros. Engineering Corp.*, 42 T.C. 419 (1964), and *Luhring Motor Co.*, 42 T.C. 732 (1964). In these cases a finance charge was added to the cash sales price by the dealers, who sold cars on a deferred payment basis. The taxpayer by law or custom was required to refund the unearned portion of the finance charge—essentially interest—upon prepayment by the buyer. The Tax Court held that the dealers were not required to include the finance charges until earned; indeed, it reached this result by analogizing the finance charge to interest: "[T]he finance charge, being similar in all respects to interest, accrues ratably." 42 T.C., at 429.

The IRS acquiesced, stating that "because of the purchaser's right to abatement, the taxpayer's right to receive the finance charge becomes fixed only through the passage of time without the purchaser making early payments." Rev. Rul. 67-316, 1967-39 Int. Rev. Bull. 7, 8. See also *Smith Motors, Inc.* v. *United States*, 61-2 U.S. Tax Cas. ¶9627 (D. Vt. 1961). This has long been the position taken with respect to advance interest of banks and other financial institutions.[1]

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[1] As to discount, see S.M. 3820, IV-2 C.B. 32, 33 (1925) ("Bank discount is the compensation charged by the bank for the use of its money, and hence is earned in the same way as interest—by lapse of time. . . ."). Actually prepaid interest appears to be accounted for by banks and other financial institutions in the same way, without apparent administrative challenge. See Banking Law Journal, *Federal Income Taxation of Banks and Other Financial Institutions* (1968), ¶5.03(a). As to discounted advance interest, see also Mertens, *Law of Federal Income Taxation* (1967), § 12.28; Prentice-Hall, *Federal Taxes* (1966), ¶7215. The Revenue Ruling as to prepaid interest on which the

Paradoxically, another panel of the court below has recently held that advance receipts are not income until earned, even where there was not any obligation to make a refund and the only factor present was the fact that the related services had to be performed at specific times. *Artnell Co.* v. *Commissioner,* 7th Cir., September 19, 1968, 68-2 U.S. Tax Cas. ¶ 9593.[2] This is in the sharpest possible conflict with the approach of the panel below which treated receipt under a claim of right as the sole determinative factor.

In the *Artnell* case, because of a corporate reorganization, the taxable year of the company operating the Chicago White Sox terminated on May 31. Prior to that date, the club had sold season tickets and single admissions, and had received revenues for broadcasts and telecasts, of games scheduled after May 31. The panel, reversing the Tax Court, held that the amounts which had been received prior to May 31 in respect of games to be played thereafter were not to be included in income in the taxable period ending May 31. It observed: "the uncertainty stressed in those decisions [the *Automobile Ass'n* and *Schlude* cases] is not present here. The deferred income was allocable to games which were to be played on a fixed schedule." 68-2 U.S. Tax Cas., at p. 88,054. Here, too, the policy loan interest was earned by the taxpayer only day by day; and the respondent conceded the propriety of this day-by-day accrual as a matter of accounting.[3]

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assessment against petitioner is based (Rev. Rul. 58-225, 1958-1 C.B. 258) is one rendered specifically in the context of the treatment of life insurance companies.

[2] The Commissioner has filed no petition for rehearing in *Artnell* and thus has made no effort to resolve the intra-circuit conflict.

[3] See p. 30, *supra.*

In holding advance unearned interest taxable, the decision of the court below appears to go further than any decided case[4] in imposing a tax on sums which a taxpayer cannot be said fairly to have earned by the close of the taxable year. Again, of itself, this factor would suggest the need for review by this Court, particularly in view of the apparent misconception below as to the effect of this Court's recent decisions in this area.[5]

2. *The Questions are of Substantial Public Importance.* —The issue as to inclusion in income of the loan interest discounted in advance is, of course, one which transcends the context of the Life Insurance Company Income Tax Act. There is nothing in the rationale of the court's opinion which would limit its holding to that context.[1] None-

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[4] With the exception of *Jefferson Standard Life Ins. Co.* v. *United States*, 272 F. Supp. 97 (M.D.N.C. 1967), *appeals pending*, *supra*, n. 22, p. 29, which deals with the same issue.

[5] For similar reasons, the court's holding that capitalized unearned interest added to the principal of a policy loan is to be included in petitioner's assets for the purposes of the computations of its taxable investment income under §§ 804-06 is erroneous. Section 805(b)(4)(B) provides that in computing assets the amount attributable to the asset shall be its basis for the purpose of determining gain on sale or other disposition; and under § 1012 of the Code, the basis of property is cost. Since petitioner has not paid anything for the capitalized unearned interest nor included anything in it in respect of income (under the view for which we contend), the capitalized unearned interest has no basis and accordingly should not be taken into account as an asset. If the Court of Appeals erred, as we contend, in its conclusion with respect to inclusion of these amounts in income, its conclusion as to their status as an asset should also fall.

[1] Indeed, it would appear that an argument is available under the Life Insurance Company Income Tax Act in favor of petitioner which is not available to taxpayers generally. The Act, at § 818(a), p. 77a, *infra*, expressly forbids life insurance companies to use, or the Commissioner to sanction the use by them, of the "cash receipts and disbursements method" of accounting. On the other hand, § 451(a), p. 78a, *infra*, of the Code which applies to taxpayers generally provides that items of gross income shall be included for

theless, the issue is of substantial importance to life insurance company taxpayers. It is important to note that because the income item in question—interest on policy loans —is an item used in computing "taxable investment income," the issues here are fully applicable to all companies, including those, such as mutual companies, whose taxable investment income may tend to exceed gain from operations.[2] (See pp. 21-22, *supra*)

At year-end 1967, United States life insurance companies had $10,059,000,000 in policy loans outstanding to their policyholders, and these loans constituted 5.7% of the companies' assets.[3] While practices vary, it is believed that a substantial number of the companies issue policies providing that interest on policy loans is to be charged in advance rather than in arrears. The responses of 169 members of the American Life Convention responding to a questionnaire in connection with the preparation of this Petition indicated that 73% had policies outstanding on

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the taxable year in which received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Petitioner's method of accounting takes the interest into account when earned, rather than received, and hence is more properly an accrual method of accounting than the cash receipts method here contended for by the IRS. Under the Act, the cash receipts method is forbidden, whereas under the Code generally it is the starting point unless another approach is appropriate for recording the time of inclusion. Nonetheless, we would contend that under either provision the items in question here should not be taken into account until earned by an accrual basis taxpayer.

[2] And the court's holding that capitalized unearned interest was to be included in the asset base likewise affects all life insurance companies, inasmuch as the size of the asset base is relevant to the computation of the taxable and nontaxable shares of investment income. See pp. 22-23, *supra*.

[3] Institute of Life Insurance, *Life Insurance Fact Book* (1968), p. 86.

which policy loan interest was charged in advance.[4] If one assumes that a similar proportion prevails among the 1,700 companies in the industry, the problem is common to over 1,200 companies. Figures published by the Institute of Life Insurance support the estimate that with respect to the United States life insurance industry as a whole, the effect of the court's ruling, with respect to 1966 alone, is to include $35,800,000 of unearned interest in investment income.[5]

Only the tip of the iceberg of litigation on this issue, too, is visible. Cases involving at least eight other companies are already pending in court.[6] But inquiry has indicated that questions have been raised by the IRS on the administrative level in a substantial number of additional cases. Of the 123 companies responding to the questionnaire circulated by the American Life Convention to its membership in connection with the preparation of this Petition who indicated that they charge policy loan interest in

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[4] See n. 21, p. 28, *supra*.

[5] The published industry-wide figure of $420,000,000 in *earned* policy loan interest (NAIC form, Exhibit 3, line 5, column 7) for 1966 here was the starting point of the estimate. An analysis of the hundred largest companies (in themselves accounting for 90% of the figure) was made to determine the average ratio of *unearned* interest (Exhibit 3, line 5, column 2) on their reports to earned interest. This ratio was then applied to the industry-wide figure.

[6] The following are the cases known to contain this issue:

*Bankers National Life Ins. Co.*, Tax Court, No. 655-68;
*Columbus Mutual Life Ins. Co.*, Tax Court, No. 1540-68;
*Eureka Life Ins. Co.*, Tax Court, No. 4513-68;
*Great National Life Ins. Co.* v. *Campbell*, N.D. Tex., C. A. No. 3-441;
*Jefferson Standard Life Ins. Co.* v. *United States*, 4th Cir., Nos. 12,326 to 12,328;
*Kentucky Central Life Ins. Co.*, Tax Court, No. 5290-67;
*Old Line Life Ins. Co.* v. *United States*, E.D. Wis., No. 68-C-149;
*Washington National Ins. Co.*, Tax Court, No. 3067-68.

advance, 91, or 74%, of the companies indicated that the Internal Revenue Service has questioned their treatment of advance interest. In 69% of the cases in which a question has been raised, a deficiency has already been assessed for one or more years. Because of the fact that so many taxable years for so many life insurance companies are still "open", the effect of this issue even on the years to date will be most substantial in terms of the processing of deficiencies and the dollar amounts involved, even taking the above figures in themselves, let alone extrapolating from them to the industry as a whole. A student of the Act recognizes this as one of the major unresolved questions as to life insurance company income taxation.[7]

Moreover, as indicated above, other financial institutions taking advance payments of interest may also be affected, although, paradoxically enough, it appears to be the case that these other institutions have been administratively permitted not to include unearned interest discounted in advance in income.[8] Thus, either a completely baseless discrimination will have to be made between the treatment of these other institutions, on the one hand, and that of life insurance companies, on the other, or the unsettling effects of the decision below will have to be applied to these other institutions. This factor and the volume of deficiencies and disputed taxes involved, as well as the conflict between the decision of the panel of the court below in this case and in the *Artnell* case, indicate that these questions, as well as the questions involving premiums deferred and uncollected, should be resolved by this Court at this time.

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[7] Schmuck, *supra*, n. 10, p. 23, at 777-79.

[8] See n. 1, p. 31, *supra*.

## CONCLUSION

For the reasons stated, this Petition for Certiorari should be granted.

Respectfully submitted,

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